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4 March 1983

Perspective

Oil Price Cuts Squeeze Persian Gulf Producers

The Arab oil producing states of the Persian Gulf—Saudi Arabia, Kuwait, the United Arab Emirates, Bahrain, Qatar, and Oman—are facing a difficult period of adjustment resulting from sharply falling oil revenues. Gulf state oil earnings fell by \$48 billion in 1982 and will probably decline by an additional \$25-50 billion during 1983. All of the monarchies are extremely sensitive to the need to maintain sufficient economic momentum to forestall political and social unrest. They will draw on their ample foreign reserves to ease the transition to less rapid economic growth and perhaps reduced benefits for their small populations. An oil price collapse would, however, force more painful spending decisions on these nations.

In Saudi Arabia, the leadership has only taken a piecemeal approach to deal with falling revenues. Some payments are being delayed, several new development projects have been put on hold, and investment for oil facilities and other capital projects slowed. Overall spending, however, remains close to last year's level and, according to our most recent data, imports were still rising.

The Saudi royal family continues to agonize over implementing any deeper spending cuts. They are reluctant to cut back on the benefits and subsidies to which most Saudis have grown accustomed. They are also committed to stepped-up military purchases and see foreign aid as a necessity to protect against radical Arab action, preserve moderate Arab regimes, and prop up a hard-pressed Iraq.

Barring an oil price collapse, the Saudis probably will procrastinate on spending decisions in the near term while drawing on their foreign reserves. As the reserve level falls, however, the government probably will become more selective in its expenditures. Capital spending will probably bear most of the burden of cutbacks although foreign aid and domestic subsidies may also be reduced.

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In Kuwait the government has already lowered subsidies and trimmed non-Kuwaiti employment in the public sector. With a potentially volatile expatriate community one and a half times the size of the native population, the Kuwaitis will be hesitant, however, to move more rapidly in reducing still generous benefits and employment opportunities—even if oil prices collapse. Depressed oil earnings probably also contributed to the crash of the unofficial stock market, an event that has tarnished Kuwait's reputation as an international financial center.

Like Saudi Arabia, Kuwait has investment earnings and foreign exchange reserves to cushion its revenue loss; investment earnings in 1982, in fact, approached oil earnings. The regime will seek to phase in gradual spending reductions while it continues its long-term policy of securing guaranteed markets for its oil through overseas acquisitions.

As for the other Gulf states, Oman, the poorest, will probably require a little more aid from its more wealthy neighbors. Its needs are modest, however, and can be satisfied with relatively little difficulty. Bahrain's economy, and therefore its prospects, are heavily tied to that of Saudi Arabia's. The United Arab Emirates and Qatar probably will be able to maintain domestic subsidies but will make some reductions in development spending. With both states still lacking coordinated, well-conceived development programs, a dose of austerity probably would help focus investment plans.

In general, the accumulated wealth of the Gulf Arab states puts them in a much better position than other OPEC countries to weather the effects of oil price cuts. If and when oil prices start to rise again, their financial strength and excess production capacity will allow them to heavily influence pricing and production policies. In light of recent experiences, Saudi Arabia and its Gulf allies are likely in the future, more than ever, to insist on a conservative OPEC oil pricing policy that does not repeat the rapid price increases of the mid-and late 1970s.



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Saudi Arabia: Financial Options

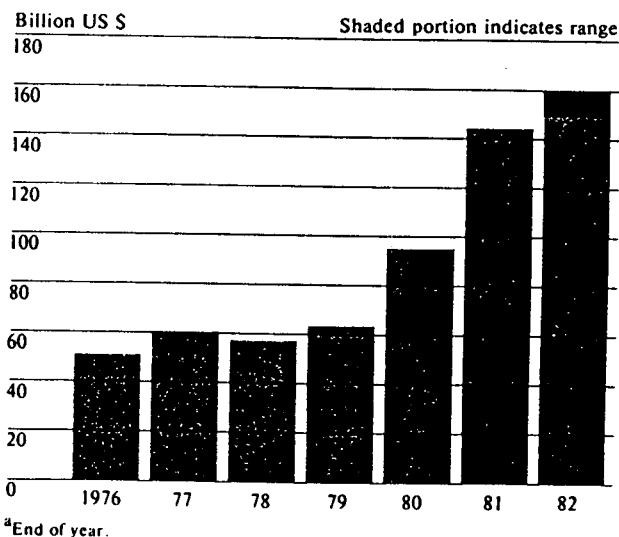
The Saudis have moved only hesitantly to slow spending despite a \$37 billion plunge in oil earnings in 1982 and the prospect of a further drop of \$20-40 billion this year. They do not want to risk a wrenching austerity program for fear of provoking domestic discontent. Neither would they want to quickly trim foreign aid because the regime sees it as protection against radical subversion and promotion of its influence in regional politics. Riyadh, however, has to contend with the possibility of oil prices sliding further and soft oil demand and reduced earnings persisting. Foreign assets of some \$150 billion allow enormous flexibility to cope with this situation, although the Saudis probably will be reluctant to continue asset liquidation at the 1983 rate of \$25 billion or more for long.

The longer oil revenues remain depressed, the more willing the Saudis will be to make more painful cuts in expenditures. Under these conditions, cuts in capital spending are likely to be the first. New construction starts, already down from earlier years, would be reduced and foreign aid may eventually be slashed. Military expenditures and domestic social programs will be spared as long as possible. A spending slowdown would reduce non-military imports, particularly affecting the United States and Japan.

The Market Setting

The soft oil market and price cutting by other OPEC producers have cut sharply into Saudi oil revenues, which account for 99 percent of export earnings and about 80 percent of domestic revenues. Earnings fell from \$111 billion in 1981 to about \$74 billion in 1982. In volume terms, oil exports in 1982 averaged only 6.3 million b/d compared with 9.6 million b/d in the previous two

Saudi Arabia: Official Foreign Assets*



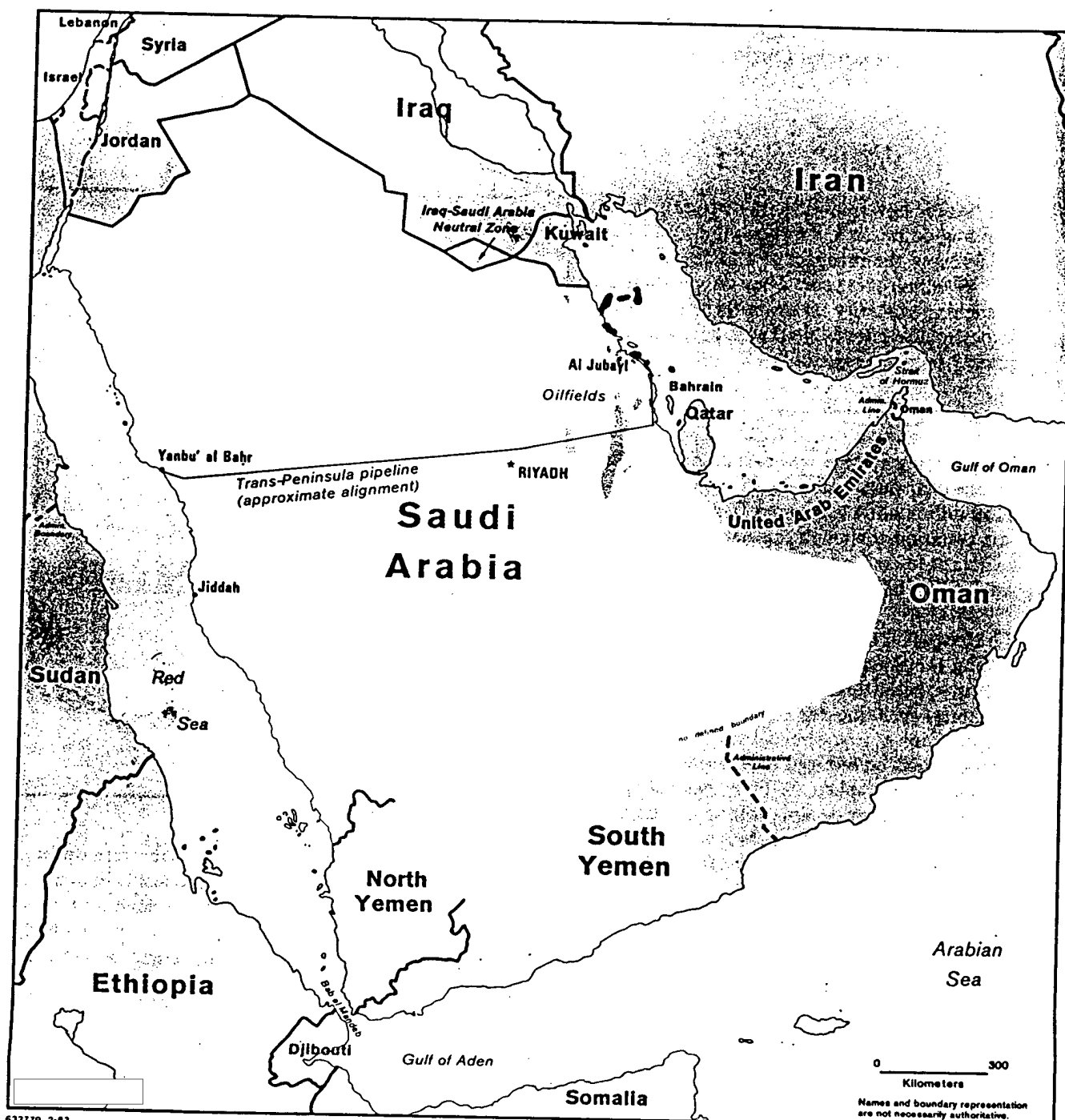
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years. By mid-February 1983, exports were down to 3.8 million b/d. Assuming a modest economic recovery in the OECD, we estimate demand for OPEC crude oil to range from 18 to 19 million b/d. The Saudi share will average an estimated 4-5 million b/d.

Spending Trends and Options

According to Saudi data, cumulative budget outlays through mid-January of the current fiscal year were running only 3 percent behind expenditures for the same period of the previous year. The

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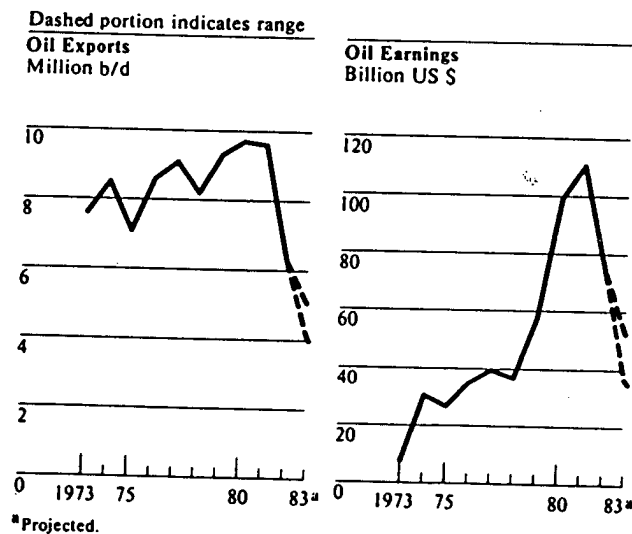


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Saudi Arabia: Oil Exports and Earnings



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expenditure slowdowns we have observed include a reduction in aid to Iraq, delayed payments to domestic contractors, and some cuts in project allocations for the large new industrial cities of Al Jubail and Yanbu Al Bahr. Some decline in outlays for local highway construction and telephone systems also has been reported. The small spending slowdown represents a sharp break from the pattern of earlier years; spending during FY78-82, grew at an average annual rate of 18 percent.

A long-term Saudi strategy to deal with falling revenues is likely to be a mix of reserve drawdowns and additional spending cuts. As long as a price war can be avoided, drawdowns are likely to be more prominent. We do not believe the Saudis will let their reserves bear the burden indefinitely, however.

Capital Spending. The US Embassy reports that allocations for new projects in the FY83 budget dropped to \$5 billion from \$24 billion in FY82; allocations for ongoing projects amounted to more than \$50 billion. Another \$18 billion for new projects is still on the books, but many may be canceled.

The Saudis have already completed much of their basic infrastructure plan. The lion's share of capital spending—over half of government outlays in recent years—went into military bases, including airfields and seaports, municipal development, transportation systems, communication networks, and education and health facilities. Now the Saudi Government is shifting investment emphasis to petrochemicals and oil refining, but given revenue constraints it is likely to attempt to get the private sector to play a larger role.

The Saudis also have substantially scaled back Aramco capital investment plans for the period 1983-87. The reductions are likely to amount to several billion dollars, much of which would be purchases of US oil equipment.

Investment in the oil sector is not included in the Saudi Government budget. The Petroleum Ministry withholds about 7 percent of oil earnings for Aramco to cover production costs and capital programs. Oil earnings at the current rate would not cover the previously planned investment program without supplemental funding from the government budget.

Riyadh will feel committed to sustaining projects already under way. Major ongoing projects include:

- Oil refineries, petrochemical plants, and iron and steel plants in Yanbu Al Bahr and Al Jubail, which are due to start operation over the next three years.
- The second phase of the Master Gas-Gathering System, the largest single project in the Saudi development plan.
- Three major desalination plants and several rural electrification programs, on which work started last year.

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Saudi Arabia: Budget Versus Actual Outlays

Billion US \$

Fiscal year	1978	1979	1980	1981	1982	1983 ^a
Current expenditures ^b						
Budget	10.8	14.0	16.2	21.2	27.1	32.0
Actual	21.0	21.1	25.0	34.1	42.1	
Overspending	10.2	7.1	8.8	12.9	15.0	
Project expenditures ^c						
Budget	22.0	24.8	31.6	52.4	60.2	59.5
Actual	19.6	23.0	31.3	36.9	42.2	
Overspending	2.4	1.8	0.3	15.5	18.0	
Total						
Budget	32.8	38.8	47.8	73.6	87.3	91.5
Actual	40.6	44.1	56.3	71.0	84.3	82-91.5

^a Budget appropriation.^b Includes salaries, subsidies, transfers to credit institutions, and foreign aid.^c Capital development spending.

Cutbacks in capital projects probably will come mainly at the expense of foreign contractors and labor. Foreigners account for one-half of a total labor force of 2.8 million, and come mainly from North Yemen, Egypt, and Pakistan. []

Military Spending. The Saudis are committed to the creation of a modern military establishment, and have some \$31 billion in the military import pipeline, predominantly from the United States. Saudi payments for deliveries are scheduled to increase by more than 40 percent in FY83 alone—to about \$7 billion—with the largest expenditures going for construction and air defense. Any cutbacks are likely to come in the awarding of new military contracts for such items as tanks, jets, and housing construction. Given the commitment to military development, we see little likelihood of more than a token drop in overall military spending in 1983. []

Other Spending. There is enough flexibility in the overall budget to allow some reductions without interfering with the basic subsidy structure and government payroll. The US Embassy speculates that the government could save as much as \$3 billion in current expenditures. "Commissions" for royal family members and other brokers in the business community probably are included in recurring expenditures. The Saudis could also slow considerably the growth in government salaries, which now total about \$10 billion and have increased in recent years. The padded government payroll employs more native Saudis than does the entire private sector. Disbursements by real estate, industrial, and other credit institutions could also be reduced. []

We see little likelihood that the government will risk popular displeasure with more than a token drop in consumer subsidies. Direct subsidies for food, agriculture, welfare, and electricity amount to

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\$3 billion in FY83. Indirect subsidies—including housing and education—are probably an equal or even larger amount.

Imports. On balance we expect merchandise imports to grow by 10 percent or less in 1983, about half the 1978-82 average annual rate. Even though the Saudis are likely to emphasize local procurement where feasible, a sustained or substantial drop in overall imports does not appear to be in the cards, in part because of the commitment to increase military spending. OECD trade statistics show that Saudi imports in the first nine months of 1982 in fact were up 20 percent from the same period of 1981; the OECD countries account for about three-fourths of total Saudi imports.

Foreign Aid. We do not expect more than a \$1 billion reduction in 1983 foreign aid payments. Although the Saudis will certainly take a harder look at aid requests, they realize that their security and influence abroad rest heavily on their cash transfers. The more radical states among the recipients probably will fare relatively better than moderate states, which pose less of a threat. Thus, we expect continued Saudi support to the Arab confrontation states, according to the 10-year commitment under the Baghdad Pact of 1978. Sizable transfers to Iraq are also likely to continue. The Saudis have provided Iraq over \$9 billion since the war between Iran and Iraq began in September 1980.

Moreover, the Saudis face other new requests for aid. They probably will provide substantial funding for reconstruction of Lebanon—if they are satisfied with the resolution of the issues and may even pay large-scale reparations to Iran on Iraq's behalf if the war ends. In a cash-strained environment, use of oil in foreign aid may increase as in a recent agreement with Sudan, essentially limiting Riyadh's cash outlay to the cost of production.

Saudi Arabia: Balance of Payments Scenarios, 1983

Billion US \$

	Case A	Case B
Trade balance	8.8	-4.8
Exports (f.o.b.)	52.6	35.2
Oil	52.2	34.8
Nonoil	0.4	0.4
Imports (f.o.b.)	43.8	36-40.0
Net services and transfers	-17.9	-16.9
Investment income receipts	13.0	12.0
Government service payments	-14.0	-12.0
Other	-16.9	-16.9
Grants	-4.5	-3.5
Current account balance	-13.6	-21.2-25.2
Capital transactions	-10.0	-7.0
Aid to Iraq	-2.0	-1.0
Other	-8.0	-6.0
Overall balance of payments	-23.6	-28.2-32.2

Assumptions	Case A	Case B
Oil exports (million b/d)	5.0	4.0
Oil price-Arab Light (US \$ per barrel, average for year)	\$30	\$25

Deficit Scenarios

The Saudi external and budget balances could vary widely depending on developments in the oil market and in Saudi spending. If the benchmark price averages \$30 per barrel in 1983,¹ oil exports aver-

¹ Benchmark prices overstate actual income because of quality differences in the export mix. The weighted average value for Saudi crude, natural gas liquids, and products is estimated to be about \$28.60 per barrel at a benchmark price for Saudi Light of \$30.

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Saudi Arabia: Domestic Budget Revenue Scenarios *Billion US \$*

Assumptions	FY1983	FY1984	
		Case A	Case B
Oil exports (million b/d)	5.2	5.0	4.0
Oil price - Arab Light (US \$ per barrel)	\$34	\$30	\$25
Budget revenues	77.0	67.0	48.9
Oil	58.0	51.0	33.9
Interest, taxes, customs duties	19.0	16.0	15.0
Expenditures	82-91.5	91.5	71.5-81.5
Deficit	-5-14.5	-24.5	-22.6-32.6

and exports average 5 million b/d. Under a worse-case revenue scenario, the deficit could top \$30 billion; a spending cut almost to the FY81 level of \$71 billion would be needed under this scenario to bring the deficit below \$25 billion.

age 5 million b/d, and import growth slows to 10 percent, the Saudi current account will be in deficit by about \$14 billion. If foreign aid to Iraq—not covered in the current account—and private capital outflows approximate recent levels, the overall balance-of-payments deficit would be some \$24 billion. The deficit could go as high as \$32 billion under a more pessimistic scenario that puts the average price at \$25 per barrel and exports at 4 million b/d. Even if the Saudis were able to cut imports by 10 percent, they would still have a \$28 billion deficit under the more pessimistic scenario.

The government's budget in FY83 will be in deficit by \$5-15 billion, depending on the rate of Saudi spending in the last three months of the year. The higher end of the deficit range assumes that the budget spending plan is fulfilled, as recently predicted by the Saudi Finance Minister; the lower end assumes continuation of outlays at the pace through mid-January—3 percent behind last year's level. Saudi officials have indicated that the FY84 expenditure will look much like the one for FY83. If so, the FY84 deficit would approximate \$25 billion if the market price averages \$30 per barrel,

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Selected LDCs: Estimated Foreign Exchange Earnings from
Worker Remittances, 1982*

	Gross Foreign Remittances (million US\$)	Origin
Bangladesh	300	Middle East
Egypt	2,000	Saudi Arabia, Iraq, Libya, Kuwait, Jordan
India	1,600	UAE, Oman, Kuwait, Qatar, Saudi Arabia
Jordan	1,100	Saudi Arabia, Kuwait, UAE, Libya
Pakistan	2,400	Saudi Arabia, Libya, UAE, Oman, Qatar
Philippines	600	Middle East
South Korea	500	Middle East
Sudan	200	Middle East
Syria	400	Middle East
Thailand	500	Middle East

* The figures cited are rough estimates that, where possible, are based on official data. They may, in fact, understate actual remittances which include some earnings not reported to the government.

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 ESTIMATED ECONOMIC AND MILITARY ASSISTANCE
 DISBURSED TO SELECTED LDCs BY PERSIAN GULF
 OPEC STATES (in millions \$US)

19811982

<u>Recipient</u>	<u>S. Arabia</u>	<u>Kuwait</u>	<u>Others</u>	<u>Total</u>	<u>S. Arabia</u>	<u>Kuwait</u>	<u>Others</u>	<u>Total</u>
Jordan	590	240	1,070	1,900	470	240	350	1,060
Morocco	520	-	-	520	500	-	20	520
Yemen Arab Republic	270	-	50	320	400	-	90	490
Oman	50	-	220	270	50	-	20	70
Sudan	230	-	40	270	180	-	50	230
Pakistan	270	-	80	350	140	-	80	220
Somalia	30	-	-	30	20	-	-	20
Iraq	4,000	2,100	2,000	8,100	2,400	2,000	1,040	5,440

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